

**VERIFICATION OF
SELECTED LOANS
REFINANCED BY THE
MORTGAGE FUND FROM
THE HOUSING GUARANTY
PROGRAM**

Prepared for



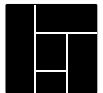
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TABLE OF CONTENTS

Introduction	1
Preparations for the Survey in Banks	2
Verification of Loan Documentation	2
On-Site Inspection of Development Financed by HG Funds	4
Interviews with Bank Officials Responsible for Approving Loans from the Mortgage Fund	5
A Comparison of Data Submitted to USAID by Bud-Bank with Bank's Own Data	7
Recommendations	8
Appendix A: Survey of Selected Loans Refinanced by the Mortgage Fund from the Housing Guaranty Program (Data from Participating Banks)	10
Appendix B: Preparations for the Survey in Banks – Critical Remarks	11

VERIFICATION OF SELECTED LOANS REFINANCED BY THE MORTGAGE FUND FROM THE HOUSING GUARANTY PROGRAM

INTRODUCTION

Pursuant to the Implementation Agreement of November 9, 1992, signed between the Governments of the Republic of Poland and the United States of America, regarding the aid for Poland's housing sector (with subsequent modifications), an annual verification of loans refinanced by the Mortgage Fund from the Housing Guaranty Program was conducted. Subject to verification were 10 out of 158 such loans contracted between April 1, 1997, until March 31, 1998. The loans were selected at random. Loan specifications are listed in Appendix A.

The aim of the survey was to determine the following:

- Whether the loan was used for the specified purpose. For example:
 - Whether the object of financing actually exists
 - Whether it corresponds with the documentation included in the mortgage loan contract
- Whether the development fulfills the provisions contained in relevant agreements between Poland and the U.S.
- Whether appropriate procedures were observed and conditions fulfilled in the process of loan approval.
- Whether the loan documentation submitted to USAID by Bud-Bank corresponds with the documentation filed with the participating bank.

Accordingly, I visited branch offices of participating banks that granted the loans selected for the survey. Essentially, each of those visits involved three components:

- Documentation survey of selected loans
- On-site inspection of the loan-financed development
- Interview with the bank employee dealing with Mortgage Fund loans approval

The visits took place between November 27 and December 11, 1998. On November 27 I visited the Jastrz"bie Zdr"j branch office of GBG; on December 1, the Krak"w branch office of GBG; on December 4, the Radom branch office of PBG; and on December 11, the Warsaw office of BISE.

PREPARATIONS FOR THE SURVEY IN BANKS

Arrangements between USAID and Bud-Bank stipulated that officials working for the latter were supposed to inform selected banks about expected coming verification.

Before I started the visits, I was given an overview of basic information concerning the loan types selected and, upon my request, names and telephone numbers of individuals who I could contact regarding my visits.

Ms. Katarzyna Lipiec responsible for approving housing credits was delegated as my assistant at the GBG Jastrz“bie Zdr“j.

At the GBG Krak“w, I contacted Ms Stefania Czuba who gave me access to credit documents and assisted me during my visit at the credited property.

My visit to the Radom branch office of PBG was the best prepared of all. The bank manager, Ms Krystyna Lipska, gave me all the help I needed. She and another bank official accompanied me on the on-site inspection of properties.

In the Warsaw branch of BISE, its manager, Ms. Luiza Golaszewska, granted me access to loan documentation. When I examined it and subsequently wanted to ask her opinion about the best way of inspecting the subject real properties, it turned out that she had left. The bank official with whom I was working at the time was unable to assist me in this respect. Consequently, using the data I had found in the loan documentation, I determined the approximate location of the real properties in question and went to inspect them.

VERIFICATION OF LOAN DOCUMENTATION

The loan documentation required by bank's procedures includes the following items:

- Mortgage loan application
- Statement of income and general information as to the financial standing of the applicant
- Tax returns for several years preceding the loan application
- Copy of the notarial deed or builder contract
- Construction permit

- Statement of appraised value of the property
- On-site inspection report
- Statements certifying that the applicant has no outstanding tax arrears or any other liabilities
- Mortgage loan contract
- Mortgage loan collateral
- Loan insurance against the risk of untimely death or permanent incapacitation of the borrower
- Correspondence of the bank with the borrower

All the documentation that was made available to me in banks is true and correct.

One of the first observations I made was that, even though the documentation is related to the same banking product, there are differences in the way borrower credit histories are maintained. (This does not imply that any of it is conducted against regulations). Out of four bank branch offices that I visited, the best (I might even say exemplary) documentation is maintained by the Kraków branch of GBG. All documents relating to the loan are clear and orderly. Moreover, the bank official who deals with Mortgage Fund loans writes commentaries regarding individual credit histories. I found those very helpful in analyzing the loan documentation. Each loan approval is accompanied by a legal expert's opinion as to the justification for granting the loan.

Not all above-listed documents are present in all individual credit histories. In some cases there were no on-site inspection reports, though bank officers assured me that such inspections had indeed taken place. I also noticed that some borrowers did not update their documentation after the loan had been granted. For example, among the documents that were missing, were the current tax returns and copies of current insurance policies.

Formally speaking, some banks do not fulfill the obligation of having the property appraised by a qualified valuer. This should not be taken to imply that banks fail to estimate the value of the property that they help finance. All branch offices that I visited either employ or cooperate with an individual who is qualified sufficiently well to appraise the property and thus secure the bank's interests. Again, only some of those individuals were formally qualified as property valuers. However, I do not see it as a decidedly negative phenomenon. It is in the bank's interest to ensure that its product be both attractive and profitable.

Among the positives, banks tend to use a broader range of available options for securing loan repayment. Apart from the traditional ones, such as real property mortgage securing an existing or future claim, ordinary mortgage, blank promissory notes, guarantors and property insurance claims transfer, banks also allow for the transfer of life insurance claims. BISE requires the borrowers to insure the loans against the risk of their untimely death or permanent incapacitation.

More serious doubts were raised by loan no. 284 approved by GBG in Kraków. In my understanding, the declared loan use did not entirely match its actual use. The borrower purchased an apartment in a multi-family house on the secondary property market. The purchase was financed in part by the borrower's own funds. The balance was provided by loans from private individuals. According to the provisions of the mortgage loan contract, the loan was supposed to finance the purchase of the property. In fact, the loan was used to repay the short-term loan that directly financed the purchase. Hence my doubts as to whether such loan use stands in agreement with the Eligible Expenditures provision of the Implementation Agreement. It must be noted, however, that the loan has already been repaid at the time, and does not involve any HG funds.

ON-SITE INSPECTION OF DEVELOPMENT FINANCED BY HG FUNDS

After consulting USAID, I decided against inspecting two properties and, therefore, I visited eight of the ten investments selected for verification. I also had the opportunity of meeting four borrowers personally. The remaining four properties I only saw from the outside. In the course of inspection I did not notice any discrepancies between the actual state of affairs and the information contained in the loan documentation.

The only doubts were raised by the following loans:

- Loan no. 334 granted by GBG Kraków. It is a mortgage loan converted from a construction loan on December 5, 1996; mortgage credit contract dated December 11, 1997; HG loan refinancing agreement dated December 29, 1997. The floor area of the subject real property is 177 square meters. According to the provisions of the Implementation Agreement in force on December 29, the maximum floor area of a single-family house eligible for the scheme was 180 square meters, with the extra condition that any area exceeding 150 square meters must be financed with the borrower's own funds. (cf. Implementation Agreement, Attachment 2, November 6, 1995). Interpreting those provision in terms of

required commitment of borrower's own funds, the documentation specified it at around 55 percent of the real property value. The balance, 45 percent, was financed with the construction loan. The mortgage loan, on the other hand, corresponded to 36 percent of the real property value. Hence the data presented above confirm the correct classification of the property as Eligible Expenditures.

- Loan no. 272.05 approved by PBG Radom. The loan contract was signed on November 28, 1996 and refinanced pursuant to the contract between the participating bank and Bud-Bank on July 31, 1997. Likewise, the loan was granted when Attachment 2 of the Implementation Agreement was in force. The usable floor area of the subject property is 178.4 square meters. The loan amounts to 20 per cent of the property value, while the refinanced loan constitutes only 10 percent of the value. Consequently, this loan also qualified as Eligible Expenditures.

INTERVIEWS WITH BANK OFFICIALS RESPONSIBLE FOR APPROVING LOANS FROM THE MORTGAGE FUND

During my visits in participating banks I conducted several interviews with banking officials regarding housing finance. Those interviews demonstrate that the volume of housing loans is on the rise.

Only GBG Jastrz"bie Zdrój grants more loans with its own funds than it does with the Mortgage Fund. The bank officer explained it in terms of simpler procedures than those involving Bud-Bank loans. Moreover, the majority of loans granted by the bank are relatively small (around 10,000 PLN). The increased loan volume can be attributed in part to good cooperation with the Miners' Housing Agency and in part to the system of compensation for retiring miners.

Other banks reported an increased share of loans involving the Mortgage Fund in the pool of credits granted by them. The most appealing aspect of those is the repayment formula that allows for the repayment of relatively modest amounts. However, the banks also notice that given unfavorable macroeconomic conditions, clients tend to be surprised that even though they repay the loan according to contractual provisions, their debt level increases, instead of decreasing.

Bank officials are unanimous in reporting that long-term mortgage loans belong to the safest of all banking products. On the other hand, they

are aware of the fact that the banks may have to resort to evictions in order to vindicate their claims.

Officials in PBG Radom reported that the formula of a mortgage loan contract required by Bud-Bank contains several ambiguous provisions that may potentially become a source of problems. Those ambiguities had been reported to the Bud-Bank, but the latter made no comment about them. Unfortunately, until now, I have not received any more detailed conclusions from PBG.

In PBG I was also informed that Mortgage Fund records are not computerized. The bank uses a comprehensive account management system (SORBA) that is incompatible with the MINISAK program. Hence both customer and product data are recorded only in the SORBA program.

At the moment, the Radom region is facing a large-scale unemployment. The situation on the labor market has become rather complicated due to the economic crisis in Russia. Many companies go bankrupt and more and more people are out of work. Among them are individuals who owe money to the bank. The bank is concerned that in the long term such a situation may lead to loan repayment difficulties.

A BISE official indicated that Bud-Bank loan form entitled "Loan Disbursement Conditions" (Sprawdzenie warunków wypłaty) is unclear with respect to the Household Monthly Income. It is not specified whether the income reported should be net, gross, for the preceding month or an average for the last year.

Furthermore, the official suggested that many potential customers are interested in obtaining loans not to finance the final phase of the development, but to pay for the initial one. It may result from the fact that some people already have a place to live, but they would like to improve their housing standard and build a house. They have no own funds that would allow them to purchase a building lot, and they do not yet wish to sell the flat they occupy at present. In such circumstances, a loan might provide funding for the first part of construction, while the sale of the flat would provide funds necessary for its completion and, possibly, a part of credit repayment.

It was also argued that present limitations of floor area of eligible property are too strict. One of the arguments was that high-income customers (and thus most desirable for banks) wish to build bigger houses. Besides, the bank cannot grant a loan to any individual who has already contracted a loan from the Mortgage Fund, has repaid it, and now would



like to expand his property. The reason why it is impossible to draw a second loan is that the joint usable surface area of the planned expansion of the property and an already existing usable area, exceed the maximum property surface permitted as eligible expenditures.

The BISE official suggested increasing the floor area limits to 200 square meters for flats (on the market one can find more often multi-story apartments) and 320 square meters for houses.

A COMPARISON OF DATA SUBMITTED TO USAID BY BUD-BANK WITH BANK'S OWN DATA

In the process of examining the documentation as submitted to USAID by Bud-Bank with the records maintained by participating banks, I noticed the following discrepancies:

- Loan no. 335.02 approved by BISE. There is an entry specifying the conversion of a construction loan into a mortgage loan. However, such a procedure does not apply in this case, since the loan was originally a mortgage loan intended to finance the downpayment in a multi-family house. I cannot find justification for such an entry in the documentation submitted to USAID.
- Loan no. 343.01 approved by the Radom branch of PBG. The property price quoted in the loan documentation is PLN 19,000 while that contained in Bud-Bank specification amounts to PLN 23,450.
- Loan no. 275.02 approved by the Jastrz"bie Zdrój branch of GBG. The purchase price in bank documentation specifies PLN 26,000, while that contained in the Bud-Bank table specifies the amount of PLN 34,000.
- Loan no. 334 granted by the Kraków branch of GBG. In my opinion the amount of converted construction loan into the mortgage loan should be PLN 109,800.
- Loans no. 286.03 and 335.02 granted by BISE had been repaid after Bud-Bank gave me the list of loans that utilize HG funds.

Apart from the above, Bud-Bank information does not contain significant differences from the records maintained by participating banks. Small differences apply to the floor area of flats (several sq. cm.) and the

purchase price of the property. Those discrepancies, however, are so insignificant as to be disregarded.

RECOMMENDATIONS

- Obtain information from Bud-Bank as to the reasons for above-mentioned discrepancies in the data submitted to USAID.
- Analyze arguments in favor of increasing the eligible floor area of property.
- If in a long term perspective, the Polish government planned to increase the scale of Mortgage Fund activities, it would become necessary to develop a computer program that would explicitly demonstrate, both to a borrower and to a bank official, the various credit repayment formulae. It would have to be compatible with programs run by individual banks (e.g., the SORBA bank account management system).
- Expand Eligible Expenditures to include liabilities incurred as a result of housing construction. This is not a novel idea on the Polish market since, e.g., PKO BP has opened up a new line of credit to repay the so-called "old-portfolio loans."
- Ease the requirements concerning the appraisal of properties eligible for long-term mortgage loans (purchases). Extend the banks' leeway in appraisal procedures. Mortgage Funds interests to be secured first on the participating bank, and should this prove impossible on the ultimate borrower.
- Conduct research concerning bank's reaction and their credit portfolios in regions where the economic development rate is decreasing.
- Encourage banks to actively aid those customers whose economic standing has deteriorated as a result of unemployment. Banks may consider the possibility of contacting Regional Labor Offices and ask them for help in finding jobs for bank customers. Additionally, banks may offer small loans to be spent on improving the qualifications of unemployed borrowers.
- Analyze the requirement of a minimum level for the first repayment of the installment on the loan. This level should depend on the



loaned sum. An indicator for the “repayment of the first installment on the loan” (first installment coverage level), at 1.5 percent should be set for lower loans, e.g., up to 10,000.00 zloties. The higher the loan the lower the indicator applied. A minimum level of this indicator should be set at the level of 1.2 percent.



APPENDIX A

**SURVEY OF SELECTED LOANS REFINANCED BY THE
MORTGAGE FUND FROM THE HOUSING GUARANTY PROGRAM
(DATA FROM PARTICIPATING BANKS)**

Borrower/ Loan No.*	Bank	Type	Floor area (sq. m.)	Purchase price (PLN)	Loan amount (PLN)	Monthly gross income (PLN)	Repayment, first installment (PLN)
Gora 286.03	BISE Warsaw	Flat purchase (primary market)	78.7	182,514	40,000 (refinanced 40,000)	4507	700
Gigier 335.02	BISE Warsaw	Flat purchase (primary market)	53.01	87,450	15,000 (refinanced 15,000)	3000	500
Lapinska 352.04	BISE Warsaw	Flat purchase (primary market)	39.73	66,000	38,000 (refinanced 38,000)	2893.9	480
PrzepiorŃka 272.05	PBG Radom	Single-family house construction	178.4	103,536	20,000 (refinanced 10,000)	1653	200
Lanczyk 327.04	PBG Radom	Flat purchase (primary market)	51.12	46,008	20,000 (refinanced 10,262.21)	1020	200
Soleccy 343.01	PBG Radom	Purchase of single-family house (secondary market)	100	19,000	9,500 (refinanced 4,750)	1149.23	95
Plaska 273	GBG Jastrzēbie Zdrój	Flat purchase (secondary market)	55.88	50,000	16,000 (refinanced 12,314.72)	1602.55	350
Szubert 275.02	GBG Jastrzēbie Zdrój	Flat purchase (secondary market)	100	26,000	19,000 (refinanced 15,200)	1422.89	209
Bebenek 284	GBG Kraków	Flat purchase (secondary market)	37.4	62,000	30,000 (refinanced 27,000)	1476.38	370
Dworak 334	GBG Kraków	Single-family house construction	177	338,566	122,000 (refinanced 109,800)	12,500	1400

APPENDIX B

PREPARATIONS FOR THE SURVEY IN BANKS – CRITICAL REMARKS

In my opinion, Bud-Bank did not fulfill all the formal requirements before the survey started. In Jastrz"bie Zdrój a bank employee told me that he had been told about "some unspecified inspection from Bud-Bank". In the course of the interview it became clear that he was unaware about the source of financing for the Mortgage Fund. Hence it was necessary to brief the employee on the structure of the Mortgage Fund and thereby justify my visit in the bank. This may be explained by the relatively short time the person had been working for the bank (less than 6 months). Likewise, in his capacity he does not have to possess knowledge that would exceed the scope of his professional activity. Additionally, the bank branch office was unaware of the fact that I would like to conduct on-site inspections of the real properties financed by the loan.

A different type of problem occurred during my visit to the Kraków branch office of GBG. Initially, I was asked to submit formal documentation to justify my visit. When I explained to the bank officials that Bud-Bank was supposed to have taken care of all details, I was informed that indeed, the bank knows the inspection, but it had not been informed in writing about its scope. In such circumstances, I asked the GBG officials to contact Bud-Bank in order to clarify the misunderstanding. After about an hour, GBG received a fax from Bud-Bank, which enabled me to proceed.

In order to prevent such misunderstandings from occurring in the future, I telephoned Bud-Bank, asking to give the remaining banks as much notice as necessary.